

# FOREIGN AID: HELP OR HINDRANCE?



**T**HERE MAY BE NO MORE pitiful sight than tides of impoverished and starving refugees; there may be no greater irony than grievous want in the Third World amidst exploding possibilities in the First World. Nearly a quarter of the world's population lives on less than \$1 a day. More than half survive on less than \$2 a day. These images and numbers are used by supporters of foreign aid to shake money out of tight-fisted politicians and keep the U.S. Agency for International Development afloat.

*BY DOUG BANDOW*

Of course, the term "foreign aid" encompasses a host of programs with different goals. Ever since the Cold War,

much U.S. assistance has primarily been political and military, dedicated to buying and subsidizing friends; the large annual flows to Egypt and Israel have nothing to do with economic development, for instance. Whatever the theoretical arguments for these sort of transfers in the past, it is hard to justify them today, other than, perhaps, to buttress fragile regimes threatened by fundamentalist Islamists, such as Pakistan. And Washington continues to pay a potentially high price by allying itself with such morally repugnant regimes.

Or take humanitarian assistance. Hard to criticize in theory, in practice long-term aid programs can create significant problems. For instance, Food for Peace shipments are more efficient at dispersing domestic agricultural surpluses than feeding starving foreigners. They also have a sad record of ruining indigenous farmers in countries like Haiti and India.

Informational and technical assistance — how to organize a stock market or run elections, for example — is useful, yet this kind of assistance is widely available from private sources, either businesses, individual philanthropists or nongovernmental organizations. The same applies to medical and scientific research; Bill Gates' \$750 million donation to the Global Alliance for Vaccines and Immunizations dwarfs what most governments can supply.

But the most important form of government "assistance" is the least justified: economic or development aid. Such programs were instituted 40 years ago when people believed the Third World was poor because it lacked money. Today we know that isn't true.

### **An Expensive Failure**

Even during the Cold War, most aid was officially extended for development purposes. Yet the result has

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## ***The case for skepticism about foreign aid is just as strong now as it was last Sept. 10.***

been an expensive wasteland, strewn with spectacular failures. For instance, Zaire received some \$8.5 billion from a multitude of sources between 1970 and 1994, but imploded six years ago. (So bad was this experience that even former USAID Administrator J. Brian Atwood has acknowledged

that "The investment of over \$2 billion of American foreign aid [in Zaire] served no purpose.") Yet in 1996 U.N. Ambassador Bill Richardson made a pilgrimage to the newly minted Democratic Republic of Congo, promising to provide \$50 million in aid to the new dictator, Laurent Kabila, despite his authoritarian tendencies and the atrocities committed by his military.

In fact, virtually every nation in crisis, from Somalia to Liberia to Haiti to Burundi, has received billions of dollars from the West. Between 1970 and 1995, aid to Africa, excluding Nigeria and South Africa, averaged 12.3 percent of the recipients' GDP, five times the peak share of much shorter Marshall Plan transfers to France and Germany.

Perhaps even more staggering is the failure to discern any positive relationship between aid levels and economic growth. The United Nations Development Program reported in 1996 that 70 developing countries were poorer then than they were in 1980; 43 were poorer than they were in 1970. USAID itself acknowledged in a 1989 report that "only a handful of countries that started receiving U.S. assistance in the 1950s and 1960s have ever graduated from dependent status." Yet 13 years later, the ideological commitment to state-led development planning funded by the West is alive and well, and the international affairs establishment has continued to push for more money.

The latest justification for underwriting assorted venal autocrats is the post-Sept. 11 imperative to "do something" about terrorism by helping developing countries. The theory is that poor people lacking hope their lives will improve are more likely to resort to violence to cause change. Of course, this approach ignores the fact that if there were such a link between terrorism and poverty, America would already have been combatting terrorists from sub-Saharan Africa and South Asia for decades.

In reality, the case for skepticism about foreign aid is

as strong today as it was last Sept. 10. Such skepticism has nothing to do with isolationism, the term of opprobrium routinely tossed at anyone who critiques any international initiative. Instead, it reflects a hard-headed analysis of the facts, a realization that the world must be taken as it is, not how people might wish it to be.

Today there is no serious dispute that markets are required for growth, and that aid cannot work in the absence of markets. There is growing agreement that assistance cannot buy market reforms. All that an increasingly beleaguered band of aid defenders now claim is that foreign assistance may be useful if extended to governments which have already adopted good economic policies.

### **Making Things Worse, Not Better**

Perhaps the best broad-based study of economic policies over the last two decades is *Economic Freedom of the World* (published by an international coalition of think tanks and updated annually) compiled by economists James Gwartney, Robert Lawson and Robert Block. They created an index measuring 17 components of economic freedom, as well as three alternative summary indexes. Although international comparisons are fraught with difficulty, two clear lessons emerge. First, economic policies matter, with better policies yielding higher rates of growth. Second, changes in economic policy affect growth rates.

For years the late economist P. T. Bauer was almost alone in criticizing the efficacy of foreign aid. But his views are now mainstream. Particularly impressive are studies by Peter Boone of the London School of Economics and Center for Economic Performance. After assessing the experience of nearly 100 nations, he concluded in a 1994 Center for Economic Performance working paper that foreign transfers had no impact on recipient country investment levels. "Long-term aid is not a means to create growth," reported Boone. As he explains, "Aid does not promote economic development for two reasons: Poverty is not caused by capital shortage, and it is not optimal for politicians to adjust distortionary policies when they receive aid flows."

Boone also reviewed the impact of foreign assistance on recipient regimes and found that it mostly benefited local political elites. Similar results turn up in research by Michael O'Hanlon and Carol Graham of the Brookings Institution. Their 1997 study, *A Half Penny on the*

*Federal Dollar: The Future of Development Aid*, supports continued aid funding, but their data actually undercut that policy prescription. They found that "the negative relationship between aid flows and performance is clear at a general level. [Moreover,] absent a sound economic framework and functioning market in a recipient country, few such efforts can work." Even after endorsing limited aid initiatives, they cautioned: "Larger initiatives are unlikely to be effective unless recipients have sound economic and demographic policies." In fact, foreign aid actually discourages reform by cushioning the price of policy failure and reducing the urgency of making politically painful changes.

Backing this conclusion, Hoover Institution scholars Bruce Bueno de Mesquita and Hilton Root report in the Summer 2002 *National Interest* that "On average, every dollar of per capita foreign aid improves an incumbent autocrat's chance of surviving in office another year by about four percent," even after accounting for a myriad of independent factors. "Since the average autocracy gets about \$8 per capita in aid, foreign assistance may boost the survival prospects of poorly performing leaders by 30 percent or more," they conclude.

With more and more countries moving towards free markets (no thanks to foreign aid), some advocates contend that there are now more places in which such transfers can play a truly beneficial role. But the fact that there might be some benefit in some limited cases is hardly adequate justification for a program that has spent, in current dollars, over \$1 trillion since World War II.

### **Can Aid Buy Reform?**

As these insights have reached Capitol Hill, spawning greater resistance to funding, assistance advocates have desperately concocted a new justification for old aid programs: the promotion of policy reform and good governance. Specifically, this increasingly beleaguered band of aid defenders claims that foreign assistance may be useful if targeted toward governments that have already adopted good economic policies.

Of course, there are cases of aid recipients that have adopted reforms. But it's hard to find any instance where there is convincing evidence that they did so because of such assistance. Take three of the most dramatic examples: China, India and the Soviet Union. All chose a reform path over the last two decades, but

foreign aid had nothing to do with that decision. Rather, all three changed course for the same reason: the old statist strategy had failed, and failed disastrously. The only alternative was reform.

Still, might there be a few cases where well-administered aid might materially speed up the development process? It seems doubtful, but even if so, to use that as the justification for maintaining foreign aid demonstrates just how far the debate has shifted. After all, if speeding up growth that would otherwise occur was a good reason for foreign aid, the U.S. itself should be a recipient. And as Heritage Foundation President Edwin Feulner notes in his preface to Heritage's *Index of Economic Freedom*, "countries with free economies generally don't need U.S. development assistance [anyway], because their economies are growing and prospering."

Indeed, success begets success. Today private capital, particularly investment, flows account for 80 percent of net long-term financial transfers, up from 30 percent a few decades ago. Net foreign direct investment increased tenfold during the 1990s, to about \$200 billion annually; total trade more than doubled, to \$4.6 trillion. Of course, private capital flows have been concentrated in particular developing states. That creates enormous risks when countries stumble, as was evident during the 1997 Asian economic crisis. But shifting investment patterns also demonstrate the power of the private marketplace to reward good policies.

That leverage is undercut, however, when donors fail to hold recipients to their promises of economic and political reform. This past June, for example, African leaders met with U.N. Secretary-General Kofi Annan to make a pitch for more aid, with the promise of better governance in exchange. But before rushing to provide more assistance, donors would do well to recall that no African government has ever been disciplined by its neighbors for corruption and incompetence.

Responding to such criticisms, Harvard's Jeffrey Sachs has variously called for "a carefully designed program," "a better focused foreign aid program," and one "limited in duration," accompanied by "a plan to phase it out." But

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there is no reason to believe that any reinvention of development assistance or reorganization of USAID would make any real difference. Given the very nature of aid, beyond the obvious problems in its administration by USAID and micro-management by Congress, targeting and more selectively appropriating assistance would

only reduce the money wasted.

### **A Cautionary Tale**

Ignoring these lessons, at the Monterrey Summit this past March, President George W. Bush coupled his announcement of the Millennium Challenge Account with a commitment to make aid more effective. But there is little reason to believe that this latest initiative will work any better than the billions spent in the past at encouraging reform.

Consider the IMF's current strategy of bailing out countries in crisis, which dates from the 1996 "rescue" of Mexico. This, too, was supposed to be an entirely new, and limited, approach to aid. But it has become both common and expensive. Charles Calomiris, a professor at Columbia Business School, argues that bailouts produce three perverse effects: "(1) undesirable redistributions of wealth from taxpayers to politically influential oligarchs in developing economies; (2) the promotion of excessive risk-taking and inefficient investment; and (3) the undermining of the natural process of deregulation and economic and political reform which global competition would otherwise promote."

First was Mexico, which was supposed to be unique. Its economy was intimately tied to that of America — the two nations had only recently inked the NAFTA trade accord — and refugees might flood across the border if prosperity was not restored. America's southern neighbor could not be allowed to fail.

The argument was never convincing, since the slump in an economy a tenth the size of America's in no way threatened U.S. prosperity. But at least the contention had some surface plausibility. And there was only one Mexico. No other developing state could make a similar claim.

Although the bailout has been widely hailed as a suc-

cess, Calomiris argues otherwise. The Mexican government has never attempted to hold responsible the original debtors after purchasing \$45 billion in bad debt from insolvent banks, causing “the transfer of billions of dollars from Mexican taxpayers collectively to the country’s wealthiest and most politically powerful enterprises and individuals. The economic result of these taxes is more than a pure transfer to the rich; taxation has also slowed recovery from the recession.” Equally significant, the banking system remains unreformed, a ticking financial time bomb.

Then came Indonesia, whose trade with America is negligible. Indonesia had been liberalizing a bit, but only a bit. The economy remained bedeviled by inefficient monopolies, insolvent banks, harmful trade barriers, wasteful food subsidies, and political favoritism. Being a relative, or married to a relative, of President Suharto was long the surest way to wealth. His back to the wall, Suharto agreed to the conditions of an IMF bailout in 1998, but did his best to resist its terms. And a succession of weak governments since his ouster has done virtually nothing to open the economy, despite repeated promises.

All of these countries — and others, such as Argentina, Brazil and Turkey — are in trouble not because of forces beyond their control, but their own policies. Politicized banks are often at the root of such economic disasters. Only after the bubbles burst — when loans go bad, companies go bust, currencies crash, foreign exchange reserves plummet, and debt repayment falters — are the countries forced to address the underlying issues. Furthermore, because borrowers in crisis are likely to do only the minimum necessary to receive aid, foreign assistance only postpones true reform. Were the countries left to their own devices, they would have to adopt all of the policies necessary to recondition their economies and reassure foreign investors, who tend to be more careful with their own cash than are international aid bureaucrats with tax monies from industrialized states.

### **The Bottom Line**

Now that Washington has intervened again and again, both bilaterally and multilaterally, what nation does not expect help? Even the supposedly tough-minded Bush administration endorsed the Turkish bailout. So much for Sachs’ idea of “a better focused” foreign aid program!

In practice, every case is judged to be exceptional, warranting intervention.

This proclivity to intervene creates a further danger, what economists call “moral hazard.” The expectation of a subsidy encourages people to behave irresponsibly, as did many owners of federally-insured savings and loans associations here in the U.S., causing the S&L crisis of the late 1980s. International aid has similar effects. Warns economist Allan Meltzer, “[foreign] banks and financial institutions can now act safe in the knowledge that the IMF will provide a safety net to protect them from some, or even most, of their losses.”

This is unfair, of course, a form of corporate welfare conducted by government institutions that act as Robin Hood in reverse. But there is an even more perverse effect. In Calomiris’ view, “by insuring foreign creditors who fuel developing economy risk-taking, the IMF and U.S. government are undermining the natural process of reform in many emerging economies.” As he explains: “The incentives for oligarchs to liberalize can be strong if foreign sources of capital are only willing to provide funds to economies with appropriate capitalist infrastructures — that is, those which are based on the rule of law, the protection of creditors and stockholders rights, a predictable means of laying claim to title, an orderly bankruptcy procedure, an intelligible system of accounting principles, a non-confiscatory tax system, and fair competition in markets ... [But if] foreign investors are protected by the IMF and the U.S. government, foreigners will be less discriminating about where they place their funds, and thus provide less of an incentive for reform in developing economies.”

For all these reasons, foreign aid has failed, despite the best efforts of many dedicated professionals at USAID, the State Department and elsewhere. Nor is reform a real option. Whereas advocates once claimed that international transfers would move developing states into the industrialized age, an increasing number of supporters now acknowledge that the only cases in which it might work are where countries have already adopted market reforms. But in those cases it is not needed.

After a half-century of failure, it’s time to stop wasting the taxpayers’ money and to look for new strategies to ease the agony that afflicts so many of the world’s peoples. ■